

CURRENCIES AND CREDIT MARKETS

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"The very effort of individuals to lessen their burden of debt increases it, because of the mass effect of the stampede to liquidate in swelling each dollar owed. We have the great paradox which, I submit, is the chief secret of most, if not all great depressions: The more the debtors pay, the more they owe. The more the economic boat tips, the more it tends to tip. It is not tending to right itself, but is capsizing."

The Debt-Deflation Theory of Great Depressions, Irving Fisher
Econometrica, Volume 1, 1933, 3. 344

HIGHLIGHTS

While global financial markets tremble over every stray sign of price inflation, the real danger goes unrecognized: Worsening global liquidity conditions — nowhere more so than in the United States.

We focus on the question, of what the investor should be more afraid of: Commodity and price inflation or a savage asset deflation — a crash. The latter is the true, big threat.

On the surface, the U.S. liquidity situation looks extremely contradictory as strong credit creation coincides with stagnant money growth. We show and explain why the general perception of abundant liquidity is a delusion.

After a thorough and comprehensive analysis of the U.S. liquidity situation, we come to disastrous findings and conclude that the ongoing U.S. liquidity crunch is the greatest potential threat to the world financial markets.

Even those who fear a possible crash look to the Fed to save the day — by "printing money". At best, the Fed can stabilize the banking system. But it would be powerless against a liquidity crisis in the markets and the vast net of nonbank financial intermediaries.

In a sense, the Fed is already "pushing on a string", given its prolonged failure to accomplish any money growth in the form of bank deposits which alone have perfect liquidity.

The dream of a global economic boom continues to support stock valuations despite the worst bond bear market in history. We place little importance on any still existing bullish sentiment in stock markets, except to note that it is doomed to disappointment.

On the other hand, world economic news are better than expected. The biggest positive surprise this year has been the speed of Europe's escape from recession. Still, the strength is more in the eyes of the beholders, less in the objective facts.

We think it is inevitable: The markets face a big negative surprise.

THIS IS NEITHER 1929 OR 1987. IT'S WORSE

Everyone insists the financial markets are so jittery because they are terrified by the threat of accelerating inflation. We think this is barking up the wrong tree. The real problem plaguing the markets is vanishing liquidity.

Recent events have raised questions over questions: Is inflation or a market crash upon us? How can inflation possibly raise its ugly head at a time of record-low global money growth? In the United States, how can an economic recovery coincide with a virtual absence of money growth? Is this monetary stagnation what the Fed really wants? Or does it reflect the inefficacy of monetary policy? If the latter is true, it would raise some uncomfortable questions about the Fed's future powers.

Confusing and contradictory? Absolutely. But as the U.S. economy continues to look reasonably strong, few investors seem to care. The puzzling behavior of the monetary aggregates is dismissed as an abstract, theoretical problem. Instead, Wall Street frets over every jump and wiggle in commodity prices, as if they and they alone can explain the frightful carnage in the bond market over the past year.

In truth, current monetary trends are an odd mix, of which it is truly difficult to make any sense. Frankly, we see no parallel in history. But to us, this is all the more compelling of a reason to investigate the riddle until we have solved it. This we have done, with the result that we can only confirm our earlier warnings: The U.S. economy and its financial system are heading into the teeth of a savage liquidity crunch which the Fed will be unable to ward off.

But while world bond markets are steadily making new lows, in line with our expectations and forecasts, world equity markets have been displaying an astounding resilience. Rising corporate earnings are most commonly cited as the reason for a sure continuation of the bull market in stocks.

We have long since given up looking for rationality in the stock market. This is especially so now, when the whole world financial community is addicted to speculation as never before in history. Since the early 1980s, both in the United States and in many other industrial countries, a tremendous infrastructure has been put in place with the outright objective of promoting financial speculation. Trading in derivatives has for many banks become the main source of profits.

Given this speculative bent, we're not too surprised that stock markets were able to stage a pronounced rally this summer in complete disregard of the global bond crash. We wouldn't waste our time pondering the reasons, especially now that the rally has crumbled with the onset of autumn.

All this nonsense reminds us of what the great historian Professor Joseph Schumpeter said about stock markets. In his 1939 book, *Business Cycles*, he branded them as particularly freakish, being prone to "irrational fancy and downright foolish hopes." Yet, he warned, over time "the real state of things is always bound to assert itself."

These occasional bouts of total irrationality in the stock markets have three main reasons, according to Schumpeter. First, stock speculation does not absorb money balances. It only raises money velocity. Velocity-driven markets by their nature tend to be volatile and erratic. Secondly, stock speculation involves a class of people "very much more excitable and very much less intelligent than these individuals who are in their own business pursuits." As a result, there is "much more scope for waves of optimism and pessimism on the stock exchange than there is in industrial and commercial business." Finally, stock market players tend to go with the crowd. Being mostly unable to make their own judgment, they generally

follow current opinion or advice which — we would add — comes mainly from experts with a vested interest in fostering speculation.

But while we can dismiss the stock market, we cannot ignore the tide of speculation driving it. Wall Street, and by extension, the U.S. dollar, clearly are the bellwethers of the world's financial markets. Ever since 1982, Wall Street has led the global bull run in bond and stock markets, making it the longest and broadest financial boom in history. Over this period, the financial service industry has virtually exploded, begetting a whole generation of traders, economists and analysts who don't have the faintest idea how to identify an approaching bear. Their worst encounter was the stock market crash of October 1987. After the trauma of the first shock, however, the crash only confirmed the wisdom of those who preach the speculative golden rule: "*always buy the dips.*" Those who followed this advice since 1987 have fared extremely well ... so far.

1929, 1987, 1994: CRUCIAL DIFFERENCES

The superficial similarities between 1987 and today have set us to mulling over the comparative economic, financial and monetary trends. We see vast differences — and not necessarily to the advantage of today's markets.

The crash of Monday, October 19, 1987 can't be described as a bolt from the blue. It, too, was preceded by collapses in both U.S. bond prices and the dollar. U.S. stocks themselves fell quite sharply in the two weeks leading up to the crash. On Black Monday the Dow Jones Industrial Average dropped 23% — an unprecedented fall in a single day — taking the Dow 34% below its early October level.

Briefly, it looked like 1929, but while the 1929 crash did turn an impending recession into a depression, the global 1987 crash had no tangible, economic effects, even though the preceding boom had created unprecedented debt excesses. Within days and weeks of the crash, it was business as usual again.

Why was the crash so harmless? Market legend holds that disaster was averted only by the Fed cajoling banks into lending to wrong-footed brokers. Above all, a statement released by Alan Greenspan, who had just succeeded Paul Volcker as Fed chairman, is regarded as crucial. "*The Federal Reserve,*" the statement read, "*consistent with its responsibilities as the nation's central bank, affirmed today its readiness to serve as a source of liquidity to support the economic and financial system.*"

It's certainly a convenient explanation for how calamity was diverted. It adds grist to the mills of the eternal bulls by feeding the impression that central banks have the power to tame any storm in the markets. But with the benefit of hindsight, we would subscribe to a very different explanation.

The salient point is that the 1987 crash, in contrast to the 1929 one, hit booming economies, not limping ones. Total real OECD GDP grew 3.3% in 1987, and 4.4% in 1988. This boom had its obvious origin in the previous global monetary overstimulation, when non-U.S. central banks attempted to stem the dollar's decline with easy money and massive interventions in the currency markets. Together, these policies produced rapid, worldwide money growth.

TODAY'S DANGER POINTS

The current bull story, currently traded in the stock markets, is that the world economy is in the early stages of a cyclical recovery that may well surprise on the side of strength. Normally, this phase in the business cycle is indeed the most bullish period for the stock markets, thanks to superior earnings growth

and high levels of liquidity in the economy. But these aren't normal times. The U.S. stock market has already touched record valuation levels, and remains elevated despite the year's debacle in the bond market. One could argue that at current levels, the stock market has discounted every possible favorable development into the future as far as the eye can see.

Meanwhile, bad news is largely ignored — even though financial maladjustments, including gargantuan budget and trade deficits, have proliferated worldwide in recent years. These have eroded potential output growth, making most economies increasingly inflation prone. While the markets correctly sense the danger there, they fail to grasp the unprecedented monetary developments that make asset deflation, not inflation, the real danger.

It often is argued that inflation is a purely monetary phenomenon, essentially driven by excess money creation. This is true, at least in the short run. But in the long-run, the inflationary bias of an economy is determined by its savings and investment ratios. They set the limits to non-inflationary money growth, and to the potential growth rate of the economy as a whole.

America's current cyclical recovery is by far the weakest in the whole postwar period. Nevertheless, it's already hitting bottlenecks on the supply side. These reflect years of industrial downsizing and under-investment and low potential growth. U.S. inflation is no longer merely a monetary phenomenon. Increasingly, it has deep structural roots. In varying degrees, this is true of most developed countries today.

G7 Money Growth
Annual, Year-over-Year %

1986	10.2
1987	9.4
1988	10.8
1989	10.6
1990	7.6
1991	7.0
1992	3.9
1993	3.8
1994	3.1

Source: IMF

Nevertheless we see asset deflation as the overriding near-term threat, thanks to the increasingly precarious condition of the financial markets and the chronic weakness of monetary aggregates worldwide. Global liquidity trends are nothing short of disastrous. In the world financial markets, we're witnessing the inevitable deleveraging of the unprecedented speculative excesses of the late 1980s and early 1990s. Meanwhile, broad money growth in the G-7 countries shows a persistent, steep decline. It's now at a postwar record low.

These two trends — financial deleveraging and stagnant money growth — are like two trains rushing full-speed towards each other on the same track. We think a spectacular crash is inevitable.

The worst case of all is the United States. Between the end of 1991 and mid-1994, U.S. broad money (M3) expanded by a pathetic \$64 billion — an annual growth rate of just 0.6%. Currency in circulation, much of it exported abroad, accounted for all of this trivial growth.

WHAT IS LIQUIDITY?

Given this abysmal record of money and liquidity growth, how could the United States nevertheless experience booming financial markets, an economic recovery and even hints of accelerating inflation? Where, then, did all the liquidity come from? Liquidity remains the key to our analysis of this paradox.

But how do we define and measure it? At first glance, the U.S. financial system still seems glutted with liquid assets, despite the bond crash. The trouble: Many assets that appear liquid to the individual are in reality illiquid for the system as a whole. Take, for example, the multi-trillion-dollar market in repurchase

agreements, or repos, generally used to finance the huge bond holdings of the yield-curve players. In a repo agreement, a speculator finds a corporation or a financial institution with overnight money to lend. He then sells to the lender, say, \$10 billion in bonds. At the same time, he agrees to buy the securities back the next day at a slightly higher price. The lender, in effect, is making the speculator an overnight loan, secured by securities. The slightly higher repurchase price represents the interest on the loan, interest the speculator is happy to pay, since it allows him to vastly leverage his bond positions.

There are two key points here. First, participants in the repo market are overwhelmingly nonbanks. This means repo lending activities do not result in any expansion of bank credit or bank deposits. Second, repo lenders count their outstanding repo agreements as part of their liquid reserves. This makes them, in a sense, a higher-yielding substitute for bank balances. Yet by their nature, these repos cannot be considered liquid assets for the financial markets as a whole.

Imagine this scenario: Some event leads to larger net withdrawals of repo loans. What happens? To meet the call, debtors would be forced to dump collateral, the bond holdings that back their repos. But this would draw money away from the buyers of those bonds. Repo liquidity would be wiped out, while forced sales would sharply depress bond prices. It could quickly turn into a contractive chain of falling dominos.

Our scenario is hardly outlandish. It more or less reflects what happened when the Fed made its first tightening move on February 4th. Indeed, lenders didn't even need to call in their money. Once bond prices began to plunge, overleveraged borrowers themselves scrambled to unwind their repos before they became trapped in losing positions. Liquidity vanished overnight.

Now, by comparison, consider what happens when a depositor draws on his liquid bank balances in order to pay a bill. He writes a check and sends it to whomever he wishes to make payment. All that happens is that funds are transferred from one bank account to another. Liquidity is neither created or destroyed. Because the money stays in the banking system, total bank deposits remain unchanged, as do total bank loans and investments. There is no repercussion whatever in the economy or the markets.

ABSOLUTE AND CONDITIONAL LIQUIDITY

To grasp the U.S. liquidity paradox and its ominous implications, it is important to distinguish between what we can call "absolute" and "conditional" liquidity.

In the rather sparse theoretical literature that addresses this distinction, the customary terms for the two categories of liquidity are "primary" and "secondary" liquidity, or "money" and "money substitutes".

Strictly speaking, only checking accounts at banks are absolutely liquid. Along with currency, they are the sole means of payment. But it's customary to include short-term assets like Treasury bills, money market mutual funds, time deposits and savings accounts in the category of perfectly liquid assets. Their conversion into demand deposits at a bank involves no sale of a longer-term asset, no credit risk, no loss in value and virtually no delay.

Here is the crucial difference between a bank balance and a repo. For their holders, repos are normally liquid assets. But for the economy and markets as a whole, they are a liquidity mirage. In reality, repos simply leverage the economy's cash. This is bullish for the markets until there are net withdrawals. Then leverage is applied in reverse, with potentially disastrous effects on money velocity and the markets.

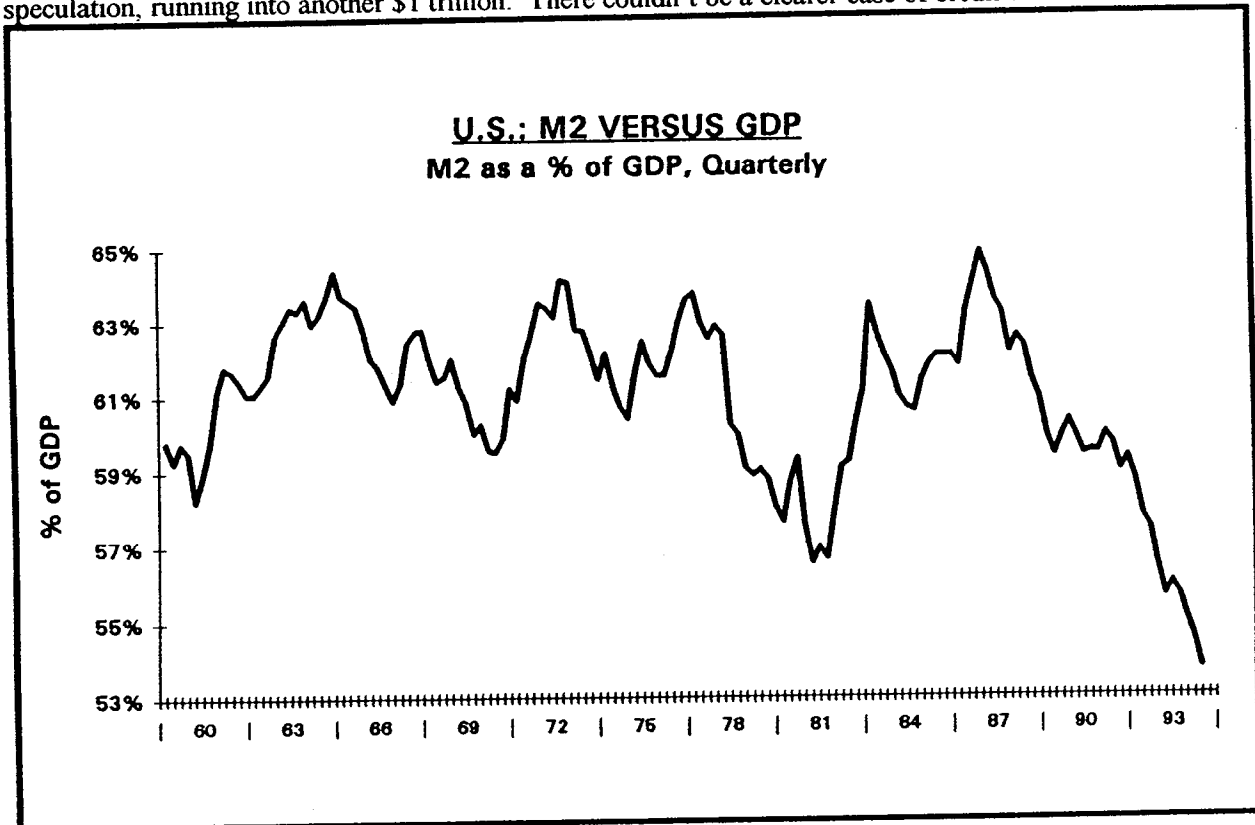
EASY MONEY AND COLLAPSING LIQUIDITY

Looking at the U.S. monetary picture, the outstanding fact is that absolute liquidity in the form of bank balances is now in its third year of zero growth. This implies that the recovering economy and the booming financial markets have lived entirely on rising money velocity. How is this possible?

Actually, the demand for absolute liquidity has always fluctuated, as the chart below shows. But two things concern us: The persistence of the steep downtrend in the liquidity ratio since 1987, which has taken it from a post-war high to a post-war low, and — the real stumper — the fact that most of this downward move has taken place at a time of ultra-easy monetary policy.

The unprecedented divergence between rampant credit growth and stagnating money growth is equally confusing. As we mentioned, broad money growth has been virtually nil for the past two-and-a-half years. Yet during that same time, total nonfinancial debt, the sum of the debt incurred by businesses, families and the public sector, has climbed by over \$1.4 trillion.

What really drives inflation, credit or money growth? In the past, this question rarely arose, because the two tended to move in lock step. But no longer. Growth in overall credit, not just bank credit, is now the key force driving inflationary trends. How much credit growth is inflationary? There the old economic rules still apply. The appropriate gauge is whether or not credit growth is expanding faster than available domestic savings. In America's case, that's exactly what has happened. The \$1.4 trillion in U.S. credit growth since 1991 has far outstripped available net business and personal savings of \$700 to \$750 billion during that same period. And that doesn't include the vast borrowings used to finance yield-curve speculation, running into another \$1 trillion. There couldn't be a clearer case of credit inflation.



HAS THE FED LOST CONTROL?

This tremendous scissor movement between credit and money, unprecedented in its magnitude, calls for explanations. We can offer two.

The first is the big shift in borrowing and lending away from the banking system to the capital markets and nonbank financial intermediaries. This has been a secular trend since at least the mid-1980s, but in recent years, it has been artificially boosted by the rapid advance of debt securitization, as well as by the abnormally steep yield curve. The wide margin between short and long rates, intentionally created by the Fed, created an irresistible temptation for all sorts of nonbank financial institutions to borrow short and lend long. The explosion in securitized markets gave them the venue in which to do it.

The decisive point here is that such credit financing outside the banking system only boosts the transaction velocity of existing bank deposits, not their outstanding amount. It multiplies credit and debt on the basis of the given money stock.

The second cause is more recent, more puzzling, and potentially even more alarming. Banks themselves have ceased to create liquidity, despite a pickup in their lending activities. Over the past 12 months, bank credit outstanding has risen \$197 billion, thanks to a surge in consumer lending and a modest pickup in investments and commercial borrowing. Normally, this growth would have its automatic counterpart in a corresponding increase in bank deposits. But this money-creation process has completely broken down. Deposits actually have fallen by over \$9 billion since August 1993.

THE BIG MONEY DRAIN

What's going on? As the overall liquidity situation worsens, the banks themselves are being squeezed. This reflects the fact that they are exposed to a powerful suction pump, which is steadily draining their deposit base. We're referring to the huge, perpetual dollar outflow through the U.S. balance of payments, chiefly due to the current-account deficit. In the past, these dollar outflows were offset or even exceeded by foreign capital inflows. But this dollar recycling process has collapsed. Still worse, U.S. portfolio outflows now exceed inflows, putting the long-term capital account into the red.

As exported dollars fail to return to the U.S. domestic banking system, banks suffer a loss of deposits, which instead pile up in the Euromarkets. In the second quarter of 1994, this net outflow of funds hit an annualized rate of \$190 billion, up from \$160 billion in the first quarter and \$154 billion in 1993. By borrowing in the Euromarkets, banks bring these expatriate dollar deposits back into the United States banking system. But the price they pay is a massive run-up in their Eurodollar liabilities. Like repos, Eurodollar instruments, too, are only money substitutes — uninsured, unsecured, and not subject to U.S. bank reserve requirements. The point here is that these Eurodollar borrowings increase the supply of bank credit in the United States, but do not increase the U.S. money supply. The ultimate effect is to further boost money velocity — piling yet another layer of leverage on top to the narrow base of U.S. bank deposits.

We have to wonder how long foreign banks will be willing to absorb all those dollars flooding into the Euromarkets. A loss of confidence could lead foreign investors to move to DM, yen and other hard currency denominated assets, causing the dollar to plunge.

THE FED HAS LOST CONTROL

What do we mean when we say the Fed has lost control of the situation? We mean that the financial system is now so riddled with gross imbalances and distortions that monetary policy has lost its mobility and efficiency.

One obvious danger we see is the heavy reliance of U.S. banks on short-term Euroborrowing to fund their own loan expansion. It is one of the fatal lessons of the 1930s that this is a dangerous ploy. It should be clear that the more than \$200 billion now owed to foreign banks could play havoc in the event of a dollar crisis. But even this is not the main reason for our belief that the Fed has lost control over credit and money. Our conclusions stem from the identification of more fundamental weaknesses in the U.S. institutional framework, and the associated adverse liquidity trends — trends which have been immensely aggravated by the Fed's prolonged stance of too low short-term interest rates.

A REMINDER OF 1929

Every crash has all of its causes in the monetary convulsion that preceded it. In the late 1920s, mushrooming broker loans to customers financed stock speculation on slender margin. The money which came mostly from corporations, played a crucial role in fueling the runaway stock market boom of 1928-29. The abrupt withdrawal of these loans was equally crucial in puncturing the bubble.

Historically, the 1928-29 surge in broker loans marked the beginning of large-scale, short-term nonbank financing in the United States. What had been exceptional became common practice in the financial markets. Lured by call money rates of 8-12% — phenomenal yields for that day and age — corporations started to lend surplus cash in the form of bank balances to brokers who, in turn, let those funds to their customers for stock speculation. Credit creation without money creation was born. While broker loans soared in 1929, total bank deposits and the money supply both stagnated.

Just for perspective: At the peak before the crash, the stock exchange reported outstanding broker loans of \$8.5 billion. This compared to total loans and investments in the entire U.S. banking system of \$35.7 billion. More than 80% of the broker loans were financed by nonbanks out of the existing money stock.

The October crash triggered instantaneous panic among the corporations and other lenders who had extended credit to the brokers and by extension to stock speculators. All of the city banks received calls from frightened customers who had used them as agents to make broker loans, instructing them to call in these loans. In the end, the lenders suffered minimal losses, but the borrowers lost most of their collateral as stock prices plunged by 53% in less than three weeks. The rapid loan liquidation dealt the markets and the economy a savage deflationary shock. And, because the collapse occurred within a few days and outside the banking system, the Fed could do nothing.

Aware of this painful episode, we have watched with growing alarm the explosive rise in short-term borrowing and lending outside the U.S. banking system. In recent years, it has even surpassed bank lending as a source of credit. By now, these short-term nonbank credits and their related "money substitutes" run into trillions of dollars. As explained, these short-term assets may look liquid enough for their individual holders, yet they are not — and cannot — be for the financial system as a whole. A wave of net redemptions could easily result in a big domino effect in the markets as happened in 1929. And just as then, the Fed could virtually do nothing against a liquidity crisis outside the banking system.

... "PUSHING ON A STRING"

There is popular belief among the American public that in case of an emergency, the Fed will simply "print money" and thus open the spigots of inflation. The big flaw in this thinking is that we no longer have cash-economies but credit-economies. Yes, central banks are the ultimate creator of liquidity through buying government bonds which, as we all know, is a main source of inflation. But to provide the necessary, big rise in the money stream to generate inflation, a central bank depends entirely on the action and reaction of the commercial banks and the financial system as a whole.

Even if a central bank has legally unlimited power to create the excess money and liquidity to fuel inflation, it does not mean that it always has the actual power to do so. It is a patent fact that aggressive monetary ease has occasionally been thwarted by the banking system and the markets. Though it happens rarely, it has occasionally happened. The most famous case of this kind are, of course, the 1930s which led to the famous expression of the Fed "pushing on a string". We see a similar failure in the United States in the offing.

In a sense, the Fed is already "pushing on a string", given its prolonged failure to accomplish any money growth in the form of bank balances which alone have perfect liquidity. This is unprecedented in the postwar period. Yet because it has neither choked the economy nor the financial boom, most commentators have drawn the simple and comforting conclusion that money growth has become obsolete and needs no more attention.

Our answer is: Yes, this money stagnation, clearly unintended, did not exert its normal contractive effects. As explained, this had a specific reason, namely, a more than offsetting sharp rise in money velocity which, in turn, resulted from soaring credit creation outside the banking system and a flight from the existing money stock into securities. The common ultimate cause of both, were the abysmally low short-term interest rates imposed by the Fed.

So there is a definite explanation for this velocity phenomenon. Basically, it means leveraging the existing money stock and depleting the liquidity of the economy and its financial system. But everybody, policymakers in the first place, ought to know that this way of increasing the money stream cannot continue indefinitely. If allowed to go too far, it spells certain disaster. Inexorably, there comes the critical point where the public wants to conserve and even to increase its liquidity with boomerang effects on the economy and the markets.

THE COMING SCRAMBLE FOR LIQUIDITY

Trying to assess the liquidity risks in the United States has to start with the recognition that liquidity — measuring bank balances as a percentage of national income or total holdings of assets — has been going downhill for years, being now at postwar lows. The second, ominous fact is the persistent absence of any new money or liquidity creation by the banks. Its continuation would essentially defeat any attempt by the public to raise its liquidity.

How do people increase their liquidity? They sell assets or cut their current expenditures. However, that works only for the individual, not for the public as a whole. Collectively, it is self-defeating because all this adds nothing to the existing pool of bank balances. All that happens is that asset prices collapse under the concerted selling pressure, wrecking the financial system as a whole. Actually, that's what happened in 1930-33.

Weighing all relevant facts, we remain asking ourselves how serious the situation really is. We think, it's in many respects much more serious than in 1929. While the banking system may be safe, thanks to assured unlimited support by the Federal Reserve, the huge network of nonbank financial intermediaries and the grossly overleveraged financial markets pose greater threats than ever. Just consider these three numbers: Total outstanding U.S. debt now amounts to more than \$16 trillion. This compares with \$38 billion central bank liquidity in the form of bank reserves and \$3.3 trillion total assets and liabilities of commercial banks.

To rebalance the U.S. financial System and to stop once and for all the speculative excesses with borrowed money in yield-curve playing, the Fed would have to raise its federal funds rate closer to long-term rates. But for fear that such an adjustment of short-term rates would finally devastate the financial markets, the Fed has to restrain itself. Any true monetary tightening, as last time in 1981-82, is no longer possible. The leveraging excesses have made the financial system too vulnerable.

We think the Fed is bound to stick to its current course of modest, incremental rate hikes, allowing both banks and nonbanks to continue adding leverage to the financial system and the markets. But by trying to avoid disaster in the short-run, the Fed sows the seeds of an even greater crisis later. The system is becoming progressively more vulnerable to sudden changes in liquidity preference. Ultimately, even a slight shift to the safety of "absolute" liquidity — bank deposits — could trigger the inevitable crash. The Fed truly has lost control.

A TURN FOR THE BETTER?

In contrast to gloomy U.S. liquidity trends, world economic news is better than expected. The biggest surprise this year has been the speed of Europe's escape from recession. All the more ominous is the immediate obsession of the markets with inflation. We think it's ludicrous. What we see is that the low-savings and low-investment countries continue to be stuck in the long run with inflation rates of 3-4% and virtually zero real income growth. The monetary potential for much higher inflation is simply not there.

Nor do we share the scare about "commodity inflation," despite the recent surge in the prices of some raw material. We see an obvious, short-term explanation in the big, world-wide inventory buildup. Above all, the price effects of this development have been magnified by the ever-present speculators, who now are banking on a global, coordinated economic boom. We do not share the view that the world economy as a whole is taking off into a self-reinforcing, self-sustaining recovery. While inventory accumulation has risen, it is still an open question whether a major upswing in fixed investment and consumption will follow.

Still, Europe's export boom has confounded earlier pessimism. The aggregate trade deficit of major European Union countries with non-EU countries fell to DM 21 billion this year, from DM 95 billion in 1992. The gains appear solidly based, being regionally well diversified. German exports to North America, Japan, central and eastern Europe and Asia have climbed by 15% to 20% year-to-year thus far in 1994. Buoyant readings for manufacturing export orders suggest exports will continue strong.

Unfortunately, no other growth engine is in sight. Fixed business investment has begun to recover after falling steeply during the recession. But consumption remains sluggish, restrained by stagnating real incomes. Given the considerable output gap that remains in continental Europe, any worries about excessive growth and inflation at this early stage are misplaced. Inflation is definitely not the danger for the so-called hard-currency countries. (Germany, Switzerland, Austria, France and the Netherlands).

Comparing the European and U.S. recoveries, the most striking difference we see is in private consumption. In the United States, it has been the key to the entire expansion. In Europe, on the other hand, private consumption has remained unusually weak. The obvious question is how long can the European export boom last, given that 60% to 70% of the Continent's total trade is intra-European.

In light of the sluggish consumption trends, and the modest recovery in business investment, we expect neither impending inflation nor general monetary tightening in Europe. Still, we wouldn't jump into longer-term bonds. The bond markets remain under potential selling pressure from outsized government budget deficits and from the potential unwinding of leveraged positions accumulated by global speculators during the recent mania.

In Germany, for example, foreigners unloaded approximately DM 50 billion in Bunds in the first five months of 1994. But this compares with net foreign purchases of DM 459 billion between 1989 and 1993. These clearly played a crucial role in forcing down German long-term rates, pushing the yield on the 10-year Bund to a low of 5.81% in January, at a time when German nonbank buyers were on a buyers' strike.

Banks have been the main prop of the German bond market during 1994. During the first half of the year they acquired, in net terms, Dm 75.5 billion, or almost 80% of net bond issues. Attracted by higher yields, nonbank financial institutions also have stepped up their bond purchases. Individual investors, by contrast, remain on strike.

As the banks also have stepped up their lending to the private sector this year, German broad money growth has soared — the exact opposite of what has happened in the United States. Between the end of 1991 and mid-1994, German M3 grew at an annual rate of 9%, compared to 0.6% in the United States. Some commentators drew from this the conclusion that the Bundesbank's policies are far more inflationary than it is willing to admit. Goldman Sachs, for example, takes this line in the September issue of its publication, *International Economic Analyst*.

Which brings us back to the question we posed earlier about the United States. How much credit growth is too much? As we said, the key cause for credit inflation is available domestic savings. Germany currently has a personal net savings rate of just over 13%, as against a bare 4% in the United States. A high savings country can afford — and indeed, needs — more credit expansion than a low-savings country. Germany's strong money growth is obviously directly related to correspondingly vigorous bank credit growth. To that extent, it might be considered inflationary. However, it appears that this expansion in bank credit is matched by a strong demand by savers for the bank balances that go into the money supply.

To put it differently: German liquidity preference is at a record high while American liquidity preference remains near record lows. Or, in Keynesian language, the Germans are super-bearish towards securities, while the Americans are super-bullish.

CONCLUSIONS

In terms of magnitude, the speculative excesses in the early 1990s clearly by far outran those in 1928-29 or 1986-87. Two other comparative negatives are these: This time, the mania engulfed both bonds and stocks, and in addition, it was a global phenomenon as never before.

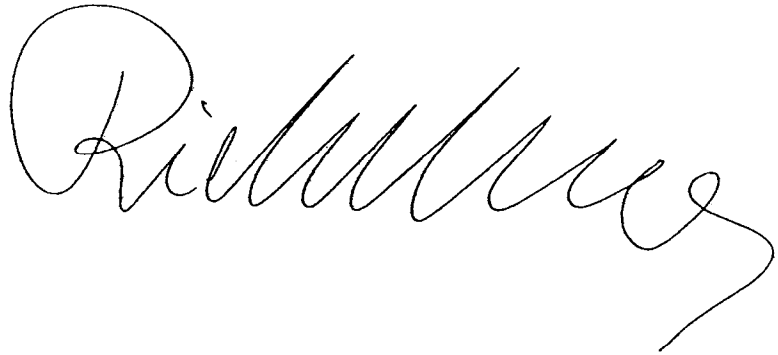
Wall Street has led the boom; now it's leading the rout. We doubt that any markets are able to decouple in the longer run.

Apparently, the international investor has not given up the idea that stock markets can still rise on the back of a world economic recovery and rising business profits. Spreading illiquidity threatens all markets.

An old adage says, "The higher they fly, the harder they fall." Eight months of sliding bond prices and attempted selling have made hardly a dent in the leveraged exposure of speculators. This is keeping bond markets under selling pressure.

Our basic recommendation remains unchanged: Liquidity is everything. We maintain a strong preference for the so-called hard currencies — Germany, Switzerland, Austria, Netherlands. But here, too, only cash or short-term securities up to about three years should be emphasized.

Please Note: Dr. Kurt Richebächer will be speaking at the dinner meeting at the upcoming meeting of the Committee for Monetary Research and Education on November 15. For information and reservations, please call or write to: CMRE, P.O. Box 1630, Greenwich, CT. Telephone 203-661-2533.



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